Views from the Trading Floor

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We would especially like to thank our partners at BNP Paribas for their assistance in putting together a fantastic trip to Brazil this past week. Debra Solomon and Francisco Oliveira in NY, and Luis Berlfein and his team in Sao Paulo helped us put together a great set of substantive meetings packed into the four day trip across Brazil. -- Andres Drobny/Dave Berry

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Drobny/BNP Paribas Global Macro Roadshow – Brazil (Sao Paulo, Brasilia, Rio de Janeiro)

January 28-January 31, 2014

Mike Dooley, Drobny partner and co-architect of the Bretton Woods II framework commented at the end of the trip: "The current global capital system/infrastructure is not capable of handling the size of the capital market stocks held in emerging markets. These foreign investment stocks have been built up over the course of a decade and there is no way everyone can liquidate. There is not enough liquidity. If this crisis escalates, we could well see gap moves in emerging asset prices. And, the pressures created by these large outflows from emerging markets may very well cause policy makers globally to consider whether foreign investment flows are worth it in the long run. We may increasingly see a tendency towards capital controls."

Summary of the Global Macro Roadshow to Brazil

Drobny/BNP Brazil hosted a global macro roadshow trip last week to Brazil in the midst of the emerging market turmoil. During the course of the trip, we met with 5 major hedge funds (including 2 highly respected former members of the Brazilian Central Bank (BCB)), Petrobras, the BCB, the Treasury Department, a political advisory consulting firm, local BNP Paribas strategists and traders, and hosted a dinner in Sao Paulo and lunch in Rio for collectively 70 portfolio managers. If I could generalize about the sentiments of the dozen foreign portfolio managers on the trip, they were bearish emerging markets/Brazil heading into the trip but they were looking for reasons to be opportunistic. One portfolio manager said he thought perhaps there might be some idiosyncratic opportunities at the beginning of the year. However, the refrain at the end of the week in Rio was that they had universally found more reasons to be bearish and concerned about owning emerging market assets. The market action last week did not help.

In addition to watching the global EMG turmoil, local portfolio managers seemed focused on the domestic fiscal and political situation in Brazil. 2014 is an election year and the country has been warned of possible downgrades by the ratings agencies in the absence of improvement in the fiscal situation (CDS is now trading at approximately 200bps). President Dilma is expected to make a major fiscal announcement in mid-February but the expectation is that the government will again overpromise (targeting a 2.5% primary surplus) and under-deliver. There is little room for maneuver fiscally since over 70% of government spending goes to wages and welfare programs (untouchable during an election year) and tax revenues have already risen from 24% of GDP in 1991 to 36% of GDP today. There is little prospect for real reform or a shakeup in the finance minister role.

At the same time, the macroeconomic fundamentals are challenging -- growth forecasts of 1-2% and inflation forecasts of 5.5-7%. The growth outlook is undermined by supply constraints, deteriorating terms of trade, lack of confidence, declining labor productivity trends and low savings rates (only 1.7% of Brazilians have a retirement account vs 60% in Mexico, 80% in Chile). And, inflation continues to be an issue -- current numbers are already understated by approximately 100-125bps due to the price controls/administrative games. Brazil seems to need a recession to begin a proper adjustment after years of excess consumption, but that doesn’t seem likely ahead of the election.

As you will see in the favorite trade discussion below -- long USDBRL is very popular -- though the extent of the position and hedging by locals is uncertain. Locals estimate it at 15-20% of portfolios. Hedge funds/smart money seem in the trade, corporates sound like they are starting to hedge, but the broader public/real money is not yet in the trade.

The meeting with the BCB on Thursday revealed more questions than answers. The senior BCB member with whom we met spent the first half of the meeting asking about the global market environment and conveyed the message that the current emerging market turmoil was to some degree out of their control. And, there was little sense that the BCB is working on a contingency plan if the crisis intensifies. The main message was that the BCB is doing its part and is already ahead of the EM curve having raised rates 325bps since midyear 2013. The BCB seems willing to allow the fx to take the pressure ("BRL depreciation is the first defense against overshooting").

This is a sentiment that was reiterated in our meeting with the local portfolio managers. The widespread belief is that the BCB is willing to tolerate an orderly fx depreciation. If the crisis in emerging market escalates in the next few weeks, the view is that the BCB will not try to fight an inevitable fall in BRL….they will likely want to save their bullets. Regarding the outlook for interest rates, there was very little discussion on inflation with the BCB. At this stage, the outlook for rate hikes seems much more dependent on the broader situation in emerging markets.

Dooley's Take

We were fortunate to have Drobny's emerging market expert, Mike Dooley leading the trip to Brazil to provide a fresh perspective. Dooley, who began his career on the international desk of the United States Federal Reserve (at the time, he was one of only two people on the international desk) and then spent approximately 15 years at the International Monetary Fund provided the following thoughts on the current situation in Brazil and more broadly in emerging markets:

If I was in my prior position at the IMF and I landed on the ground today and took a fresh look at this economy, I would make the following observations: Brazil is in much better shape today than historically had been the case. The fiscal situation and trend is easy to fix -- a modest fiscal adjustment (1-2% of GDP) would put the fiscal trends back on track. Politics seem to be the main constraint. But to blame the current situation in Brazil on political figures alone is not the right way to think about the problem.

In the current environment, the focus on monetary policy and whether and how much to raise interest rates is misguided since the BCB only controls the Selic rate. They don't control the public/BNDES rate where the growth in lending has been occurring. This lending rate is determined by 2 people -- President Dilma and the finance minister Montega. The BNDES rate hasn't changed materially during the course of the 325bps tightening by the BCB.

The larger challenge is the macroeconomic backdrop. Total productivity growth has declined meaningfully. Through discussions with the local funds it seems like this productivity decline is being driven by a shift of jobs from manufacturing to services sector, growth of government spending as a pct of economy, and perhaps to some degree by a lack of confidence in the government. And, the unwind of the commodity cycle creates issues for terms of trade which are still near their highs -- extremely vulnerable to further downside.

External pressures create an even tougher environment. The improvement in the US economic outlook only adds to the pressures. Fed tightening cycles historically have lead to emerging market crises. On average, EMG markets have had to raise rates 2.5-3 times as much as the Fed during these periods. And, I still remain constructive on the outlook for the U.S. economy. The deleveraging process is largely complete. Fiscal tightening is moving to the rear view mirror. Pent up demand for autos and housing will provide a tailwind. And, there could very well be a bump in activity in the next 6-8 weeks as the weather warms in March/April time period after a record cold winter. With that backdrop, I expect that the Fed will tighten sooner and more than currently anticipated. The emerging market crisis will not impact this outlook unless it leads to a significant decline in developed market assets.

Brazil is extremely vulnerable to capital outflows despite higher nominal rates because of the FX vulnerability. Brazil is in need of a significant devaluation on the order of 40-50% to reset the economy and regain competitiveness. [The need for a large FX devaluation was a sentiment that was echoed by the two former BCB members with whom we met]. ***Until a devaluation occurs, Brazilian assets will remain unattractive to potential buyers in effect creating a buyer's strike. The potential for gap moves in emerging market asset prices is rising. This is likely to become more readily apparent as this emerging market crisis evolves. At present, there still seems to be a belief that this might be a short-lived period of turmoil in emerging markets. I don't believe that is the case. This is likely to be a new regime for emerging markets characterized by heightened volatility in currencies and interest rates. Even at elevated levels of implied volatility, I am considering various vol trades.***

In terms of thinking about the potential size of the current disruption, measuring short term capital flows is not the most important focus. The stock of foreign investment in Brazil (and other emerging markets) over the past decade is massive and dwarfs the amount of FX reserves at the BCB. As a result, Brazil has essentially ceded control over its macroeconomic policy to foreigners by having allowed such huge amounts of foreign investment. If foreigners decide to pull their money in size, the BCB reserves will become almost meaningless.

More generally, the current global capital system/infrastructure is not capable of handling the size of the capital market stocks held in emerging markets!!! These stocks have been built up over the course of a decade and there is no way everyone can liquidate. There is not enough liquidity. If this crisis escalates, the pressures created by these large outflows from emerging markets may very well cause policy makers globally to consider whether foreign investment flows are worth it in the long run. We may increasingly see a tendency towards capital controls."

Dave Berry

As always, we asked participants at the events for their Favorite Trades:

Sao Paulo Dinner -- Wednesday January 29th

1. Long Nikkei currency hedged, short emerging market equities.
2. Pay Dec 16 Eurodollars
3. Long USDCNH ATM straddles at 2.8%
4. Long USDCLP -- mining sector slowdown
5. Long USDCLP
6. Long 2042 Greek bonds

7. Short 10yr treasuries, receive front end NZD
8. Short PDVSA (Venezuelan oil co) 2014 bonds, long duration in treasuries
9. Buy MXN CDS protection, Sell BRL CDS protection
10. Short MXNJPY tactically
11. Long USDBRL
12. Long USDCAD, continued C/A deterioration. Financing the deficit will prove difficult this year.
13. Short ARS
14. Short 1 year Eurodollar vega
15. Buy risk reversals on EMG fx, vols and risk reversals have been lagging the spot move
16. Long BRLMXN as the bad news is priced and Mexico has yet to see any significant outflows of foreign investment.
17. Sell BRL CDS as the downgrade is largely in the price at 200bps
18. Long USDCAD
19. Steepening in local USDBRL rates curve
20. Short Turkish equities, avg annual decline of close to 40% the past few years will be followed by another bad year. On long side, would focus on Taiwanese equities.
21. Long USDBRL
22. Receive belly of the local rates curve 2017-2021 and short term risk reversals in USDBRL
23. Long USDBRL
24. Long GBPCHF on the expectation that the BOE will be the first mover this year.
25. Receive 1 year Hungary, long EURHUF
26. Long USDBRL, short local rates
27. Short emerging market equities
28. Short soybeans
29. Long MXNBRL -- just the beginning of the deleveraging cycle and long EURHUF tactically
30. Long USDBRL
31. Short BRLMXN on diverging fundamentals
32. Steepener in local curve 2016-2017, carries positively
33. Short SP500
34. Short SP500
35. Short CHF, long BRL risk reversals
36. Short soybeans, long sugar (drought in Brazil)
37. Curve flattener in Turkey, short IBEX
38. Long USD v. basket of EMG fx
39. Long Israeli Shekel
40. Long USDBRL, July 2014 DI receivers
41. Long MXNBRL
42. Pay front end MXN
43. Long SP500, short US Tips
44. Short SP500

Rio de Janiero lunch-- Friday January 31

1. Long USDCLP -- central bank of Chile on your side
2. Short copper, implieds still pretty low
3. Long 5-10 delta risk reversals on EMG fx. Wary of the large stock of foreign capital in local emerging market assets.
4. Short ARS
5. Long USD globally, including against BRL
6. Short Bovespa
7. Long USDBRL
8. Long GD4 cmdty v Libor
9. Long USDBRL
10. Long USD/EMG fx
11. Sell emerging market assets
12. Long USD/EMG
13. Long USD
14. Long USDBRL
15. Long breakeven inflation in BRL
16. Long USD/BRL (but listening to this group I am concerned about consensus)
17. Short Euro -- concerned about AQR and European stress revival in this environment
18. Long US equities/short Tips
19. Short SP500
20. Pay Japanese 5 year CDS, looking for Abenomics to be tested by markets in an environment of emg crisis.
21. Slow, steady decline of BRL
22. Long Brazilian breakeven inflation
23. Real fx rate adjustment in BRL
24. Short EMG equities
25. Long breakeven inflation in BRL
26. Tactically starting to receive local rates in BRL
27. Short SP500

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